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No. 06-484

In the Supreme Court of the United States

TELLABS, INCORPORATED AND RICHARD C. NOTEBAERT,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF FOR THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION AND THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF THE *AMICI CURIAE*

The Securities Industry and Financial Markets Association (SIFMA) is a trade association that results from the November 1, 2006 merger of the Securities Industry Association and The Bond Market Association. It brings together the shared interests of more than 650 securities firms, banks, and asset managers. SIFMA's mission is to promote policies and practices that expand and improve markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests in the United States and globally. It has offices in New York, Washington, D.C., and London.

The Chamber of Commerce of the United States of America ("Chamber") is the world's largest business federation. The Chamber's underlying membership includes more than three million companies and professional organizations of every size, in every industry sector, and from every region of the country. An important function of the Chamber is to represent the interests of its members in matters before Congress, the Executive Branch, and the courts. To that end, the Chamber regularly files *amicus curiae* briefs in cases that raise issues of concern to the nation's business community.[1]

The question presented here—the proper test for determining the sufficiency of scienter allegations in securities fraud cases—is an issue of recurring importance to public companies, to the financial services industry, and to investors. *Amici* have a vital interest in ensuring that the standards of the Private Securities Litigation Reform Act ("PSLRA"), which Congress passed to curb vexatious litigation, are not

[1] Pursuant to Rule 37.6, *amici* affirm that no counsel for a party authored this brief in whole or in part and that no person other than *amici* and their counsel made a monetary contribution to its preparation or submission. The parties' consents to the filing of this brief are on file with the Clerk's office.

weakened and are properly applied. Rather than repeat petitioners' legal arguments, this brief describes the substantial practical harm that would result to issuers, investors, and the Nation's financial markets from the Seventh Circuit's lax approach to pleading scienter.

SUMMARY OF ARGUMENT

To avoid dismissal, the PSLRA requires plaintiffs bringing claims for securities fraud to plead "with particularity" facts that give rise to a "strong inference" of scienter. 15 U.S.C. § 78u-4(b)(2). The Seventh Circuit held that plaintiffs satisfied that heightened pleading requirement by alleging facts from which a reasonable person "could infer" scienter. Pet. App. 20a. The Court should reject the Seventh Circuit's overly permissive "could infer" test and instead hold that plaintiffs alleging claims for securities fraud must plead facts that strongly tend to exclude innocent explanations for the challenged conduct.

As we explain below, the Seventh Circuit's "could infer" test moves in the opposite direction from that chosen by Congress, easing plaintiffs' pleading burden and encouraging the abusive strike suits that the PSLRA set out to prevent. The Seventh Circuit's test allows Section 10(b) suits based on speculative scienter allegations to evade early dismissal. It thereby enables plaintiffs wielding abusive discovery demands and the threat of massive class action jury awards to coerce defendants into settling meritless claims. The costs of these "blackmail settlements" limit the resources corporations have available to hire additional employees and develop useful products, while making it more difficult for them to attract high-quality professionals to sit on corporate boards and provide auditing and other services essential to capital formation. Abusive securities fraud litigation is also driving foreign companies away from the United States' public markets, with two recent bipartisan reports warning that the United States risks losing its position as the leader in the global financial marketplace unless the threat of runaway class action liabili-

ties is contained. And companies are reluctant to disclose information about their future prospects to investors for fear of being exposed to a strike suit should their predictions turn out to be overly optimistic.

The high costs imposed by abusive securities fraud litigation far outweigh any benefits that a broad scienter rule might provide. Diversified shareholders generally break even from investments in securities impacted by delayed release of information even before considering recoveries from litigation, which provide only minimal compensation while extracting wasteful transaction costs. There are a host of judicial and administrative remedies available to investors that more efficiently vindicate the policies underlying the securities laws. There is no reason, accordingly, for this Court to allow Section 10(b) suits based on conclusory allegations of scienter to escape early dismissal.

ARGUMENT

I. THE BACKGROUND OF THE PSLRA'S ENACTMENT DEMONSTRATES THE NEED FOR A RIGOROUS SCIENTER STANDARD.

The Seventh Circuit held that plaintiffs may escape dismissal of a Section 10(b) claim by pleading facts from which a reasonable person "could infer" scienter. Pet. App. 20a. But Congress enacted the PSLRA to create a "more stringent" scienter pleading standard that bars speculative strike suits and thereby prevents plaintiffs from wielding the threat of litigation costs and massive class action jury awards to coerce defendants into settling meritless claims. H.R. Conf. Rep. No. 104-369, at 41 (1995), reprinted in 1995 U.S.C.C.A.N. 730 ("H.R. Conf. Rep."). This Court should insist on a rigorous pleading standard that screens out conjectural claims of scienter.

1. To understand Congress's goals in enacting the PSLRA, we begin with a description of the problems that prompted that legislation. During an "'ebullient' stage" in the development of implied causes of action, this Court found an

implied cause of action under Section 10(b) even though there is no indication that Congress "considered the question of private civil remedies under this provision." *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 729-730 (1975); LOSS & SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 1025 (3d ed. 1995). To prevent this "judicial oak" grown from a "legislative acorn" from resulting in "'liability in an indeterminate amount for an indeterminate time to an indeterminate class,'" this Court has invoked various "policy considerations" in repeatedly rejecting "expansive imposition of civil liability" under Section 10(b). *Blue Chip Stamps*, 421 U.S. at 737, 739, 748.

The Court has recognized that Section 10(b) suits "presen[t] a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Blue Chip Stamps*, 421 U.S. at 739; see *Merrill Lynch* v. *Dabit*, 126 S. Ct. 1503, 1510 (2006). It has observed that the risk of crippling jury awards means that "even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment." *Blue Chip Stamps*, 421 U.S. at 740. The threat of costly and disruptive discovery adds an additional "*in terrorem* increment" to the settlement value of even meritless claims. *Id.* at 741. And the benefits to shareholders of an expansive Section 10(b) claim—which "'will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers'"—are uncertain at best. *Id.* at 739.

Accordingly, this Court has limited the scope of Section 10(b) actions repeatedly to curtail their coercive potential and make meritless claims easier "'to dispose of before trial.'" *Blue Chip Stamps*, 421 U.S. at 742-743; see *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) (requiring proof of scienter, not mere negligence); *TSC Indus.* v. *Northway*, 426 U.S. 438 (1976) (rejecting lax definition of materiality); *Santa Fe In-*

dus. v. *Green*, 430 U.S. 462 (1977) (limiting Section 10(b) to manipulative or deceptive conduct); *Schreiber* v. *Burlington Northern*, 472 U.S. 1 (1985) (confining Section 14(e) to manipulative acts that involve misrepresentation or nondisclosure); *Central Bank* v. *First Interstate Bank*, 511 U.S. 164, 189 (1994) (rejecting aiding and abetting claims because they would engender "uncertainty and excessive litigation"); *Dura Pharmaceuticals* v. *Broudo*, 544 U.S. 336 (2005) (requiring that loss causation be pled).

2. Despite these judicially imposed limitations, "nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests, and 'manipulation by class action lawyers of the clients whom they purportedly represent'" continued to "resul[t] in extortionate settlements, chilled any discussion of issuers' future prospects, and deterred qualified individuals from serving on boards of directors." *Dabit*, 126 S. Ct. at 1510-1511 (quoting H.R. Conf. Rep. at 31). Congress enacted the PSLRA in response to "significant evidence of abuse," which undermined "American capital markets" and caused "serious injuries to innocent parties" who were "forced to pay exorbitant 'settlements.'" H.R. Conf. Rep. at 31-32. In doing so, Congress sought "to protect investors, issuers, and all who are associated with our capital markets from abusive securities litigation." *Ibid.*

The PSLRA's heightened pleading requirements—including the requirement that plaintiffs plead a "strong inference" of scienter—formed a key part of Congress's effort to curb abusive Section 10(b) suits. *Dabit*, 126 S. Ct. at 1511. The flood of Section 10(b) class actions filed since the stock market bubble burst in 2000—together with the "rise in settlement sizes to new and unprecedented levels"—confirms that the need for a rigorous scienter standard remains acute. Pet. 17; INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 75 (Dec. 5, 2006), available at http://tinyurl.com/yqdy8n ("INTERIM REPORT").

II. THE SEVENTH CIRCUIT'S "COULD INFER" TEST UNDERMINES CONGRESSIONAL INTENT AND WOULD DO MORE HARM THAN GOOD.

The Seventh Circuit's permissive scienter pleading rule "would bring about harm of the very sort the [PSLRA] seek[s] to avoid," *Dura*, 544 U.S. at 347, and "'will ultimately result in more harm than good.'" *Hochfelder*, 425 U.S. at 214 n.33. The Seventh Circuit's rule would cause a host of negative consequences for public companies, investors, and the financial markets while providing no countervailing enforcement benefits.

A. Allowing Cases With Speculative Scienter Allegations To Evade Dismissal Creates Coercive Pressure To Settle Even Meritless Section 10(b) Suits.

Once a Section 10(b) case survives dismissal, Congress understood, plaintiffs can use discovery "to impose costs so burdensome that it is often economical for the victimized party to settle." H.R. Conf. Rep. at 31; see also H.R. Conf. Rep. No. 105-803, at 13 (1998) (companies often settle strike suits "simply to avoid the potentially bankrupting expense of litigating"). Indeed, "fishing expedition" discovery accounts for 80% of the costs of defending Section 10(b) suits. H.R. Conf. Rep. at 37. Discovery also requires "key employees" to spend time responding to discovery requests and being deposed. *Ibid.* This Court has observed that discovery abuses may exist in Section 10(b) cases "to a greater extent than they do in other litigation": "extensive deposition of the defendant's officers and associates and the concomitant opportunity for extensive discovery of business documents is a common occurrence." *Blue Chip Stamps*, 421 U.S. at 741.

That discovery burden falls disproportionately on defendants, who "posses[s] the bulk of the relevant information." H.R. Rep. No. 104-50, at 16 (1995); see PERINO, SECURITIES LITIGATION AFTER THE REFORM ACT § 4.01A, at 4013 (2006) (Section 10(b) defendants face "asymmetrical discovery burdens"). Plaintiffs have little incentive to limit abusive discov-

ery demands because class members possess few documents that could be subject to burdensome requests. See Easterbrook, *Discovery as Abuse*, 69 B.U. L. REV. 635, 643, 645 (1989) ("Large litigants have files—warehouses of files. The adversary can demand that they be searched, at great cost; the adversary can notice the depositions of 20 corporate officers. What can the large litigant do to retaliate?"). And to the extent that the discovery process "permits a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the process will reveal relevant evidence, it is a social cost rather than a benefit." *Blue Chip Stamps*, 421 U.S. at 741.

Beyond massive litigation costs, the Section 10(b) suits reflexively filed after every downward fluctuation in stock prices carry the risk of enormous jury awards to a large class of plaintiffs. "[B]asic economics" can force defendants to settle "meritless" class actions that have "only a five percent chance of success." S. Rep. No. 109-14, at 21 (2005), reprinted in 2005 U.S.C.C.A.N. 3; see also *Coopers & Lybrand* v. *Livesay*, 437 U.S. 463, 476 (1978); Fed. R. Civ. P. 23(f), 1998 Comm. Note. If a Section 10(b) suit survives dismissal and a class is certified, the risks of a jury trial are so enormous that defendants have little choice but to settle. See WILLGING ET AL., EMPIRICAL STUDY OF CLASS ACTIONS IN FOUR FEDERAL DISTRICT COURTS: FINAL REPORT TO THE ADVISORY COMMITTEE ON CIVIL RULES 184 table 40 (1996). However meritless the suit, corporate executives are "unwilling to bet their company that they are in the right." *Blair* v. *Equifax Check Servs.*, 181 F.3d 832, 834 (7th Cir. 1999). There is widespread agreement that this phenomenon of "blackmail settlements," "induced by a small probability of an immense judgment," poses a serious problem. *In re Rhone-Poulenc Rorer Inc.*, 51 F.3d 1293, 1298 (7th Cir. 1995) (quoting FRIENDLY, FEDERAL JURISDICTION: A GENERAL VIEW 120 (1973)).

The "hydraulic pressure on defendants to settle" (*Newton* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 164 (3d Cir. 2001)) is particularly acute in securities fraud class actions, which "have a much higher settlement rate than other types of class actions." S. Rep. No. 104-98, at 6 (1995), reprinted in 1995 U.S.C.C.A.N. 679. Settlement costs in securities fraud class actions are now at an all-time high, with seven of the ten largest settlements ever occurring during the past two years. Coffee, *Nobody Asked Me, But . . .*, N.Y.L.J., Jan. 18, 2007, at 5. Corporations paid $9.6 billion to settle securities fraud class actions in 2005 alone, up from $2.9 billion in 2004. Davies, *Moving the Market: Class-Action Pay Settlements Soar*, WALL ST. J., Feb. 7, 2006, at C3 (noting that the overall figure is the largest ever even after excluding the WorldCom and Enron settlements); see CORNERSTONE RESEARCH, POST-REFORM ACT SECURITIES SETTLEMENTS—2005 REVIEW & ANALYSIS (2006), available at http://tinyurl.com/ywhf7w. As former SEC Chairman Arthur Levitt observed, if the defendant "cannot win an early dismissal," simple economics "may dictate a settlement even if the defendant is relatively confident that it would prevail at trial." S. Rep. No. 104-98, at 7.

Empirical studies confirm that "the merits do not matter" in Section 10(b) class actions that proceed beyond the dismissal stage. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 501 (1991) (Section 10(b) became "a grotesquely inefficient form of insurance against large stock market losses" that "encourages the filing of more and weaker suits"). Bet-the-company damages claims and massive litigation costs coerce defendants into paying settlements that are neither "voluntary," because the risks make trial not "a practically available alternative," nor "accurate," because "the strength of the case on the merits has little or nothing to do with determining the amount of the settlement." *Id.* at 499; accord Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J. L. ECON. & ORG. 55 (1991).

Few securities cases settle before the trial court rules on a motion to dismiss. But the pressure to settle weak suits becomes irresistible once dismissal is denied, discovery begins, and a class is certified. The Seventh Circuit's lax standard for pleading scienter, by failing to screen out conjectural Section 10(b) claims at the earliest stages of litigation, enables plaintiffs to exert this "hydraulic pressure" on defendants to settle cases with little relationship to the merits. It runs directly counter to Congress's attempt in the PSLRA to make the merits relevant once again by eliminating insubstantial suits at the pleading stage, before they impose coercive consequences.

B. Abusive Securities Fraud Suits That Survive Dismissal Burden The Economy And Reduce The United States' Competitiveness In The Global Marketplace.

The costs of abusive litigation are "'an Achilles heel for our economy.'" Solomon, *Treasury's Paulson Warns of the Costs of Rules Overlap*, WALL ST. J., Nov. 21, 2006, at A2 (quoting Secretary of Treasury). A recent study of 500 securities fraud class actions filed after passage of the PSLRA concluded that they destroyed at least 3.5 percent of the equity value of the defendant, resulting in $25 billion in shareholder wealth being "wiped out just due to litigation." THAKOR, THE UNINTENDED CONSEQUENCES OF SECURITIES LITIGATION 14 (U.S. Chamber Institute for Legal Reform 2005), available at http://tinyurl.com/26d57f. Start-up companies—targeted by the plaintiffs' bar because of the volatility in their share price—"bear the brunt of abusive securities fraud lawsuits" and suffer a disproportionate loss of equity value from litigation. S. Rep. No. 104-98, at 9; see *Securities Litigation Reform Proposals: Hearings on S. 240, S. 667, and H.R. 1058 Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 104th Cong., 1st Sess. 110 (1995) (half of Silicon Valley companies have been subjected to securities fraud class actions).

By reducing the equity value of defendants, abusive securities fraud litigation results in lower capital investment, which in turn "has obvious implications for job creation and economic growth." THAKOR, *supra*, at 14. "Instead of spending money on research and development or hiring more employees or reducing the cost of their products," Section 10(b) suits force companies to "spend that money on strike suit insurance and legal fees." H.R. Rep. No. 104-50, at 20.

Section 10(b) litigation also has enormously destructive ripple effects. A "fear of baseless and extortionate securities lawsuits" has made it "'extremely difficult to attract qualified, independent people to sit on corporate boards,'" which in turn has injured "the investing public and the entire U.S. economy." S. Rep. No. 104-98, at 21; H.R. Conf. Rep. at 31-32; see INTERIM REPORT at 11-12. Fear of strike suits extends to investment bankers, accountants, and other professionals whose services are essential to capital formation and efficient market operation, driving up the cost of their services and causing some to decline higher-risk engagements. S. Rep. No. 104-98, at 21-22; see also *id.* at 9 ("Underwriters, lawyers, accountants, and other professionals are prime targets of abusive securities lawsuits. The deeper the pocket, the greater the likelihood that a marginal party will be named as a defendant"). The difficulty of obtaining high-quality professional services falls disproportionately on "newer and smaller companies" because their "business failure would generate securities litigation against the professional." *Central Bank*, 511 U.S. at 189; H.R. Rep. No. 104-50, at 20.

There is also bipartisan consensus that the threat posed by securities fraud class actions deters foreign companies from entering the United States' public markets. The independent Committee on Capital Markets Regulation recently concluded that "the United States is losing its leading competitive position as compared to stock markets and financial centers abroad" in part due to the growth of "liability risks" that are absent overseas. INTERIM REPORT at ix-x. The United States' share of initial public offerings ("IPOs") issued by

foreign companies declined from 50 percent in 2000 to only 5 percent in 2005. *Id.* at 29. In 2005, 24 of the 25 largest IPOs worldwide were issued in markets outside the United States, with 9 of the 10 largest IPOs issued during the first 9 months of 2006 taking place in foreign markets. *Id.* at 30. Even domestic companies have begun fleeing the United States' markets. Twenty-three percent of IPO funds raised by domestic companies in 2005 were raised abroad. *Id.* at 32.

When foreign companies do raise money in the United States, they increasingly do so through the private equity market, which "has become foreign issuers' market of choice for U.S. equity issues." INTERIM REPORT at 46. In 2005, 90 percent of international equity issued in the United States (by volume) was completed in the private market, up from 50 percent in 1995. *Ibid.* Because "only institutions and wealthy individuals can participate directly in [the private equity] market," the average investor is left "in increasingly less liquid and more expensive markets than those enjoyed by institutions and the wealthy." *Id.* at 34. The "increasing preference" for private equity markets "is particularly telling given the lower cost of capital in the public markets," which "strongly suggests that the regulatory and litigation burden is an important factor in the choice between public and private markets." *Id.* at 46.

The Committee on Capital Markets Regulation concluded that the threat of litigation constitutes a principal reason for the decline in offerings by foreign companies in the United States' public markets. Securities fraud class actions are nonexistent in the United Kingdom and other major foreign markets. INTERIM REPORT at 71. By contrast, securities class action settlement costs in the United States stood at $9.6 billion in 2005. *Id.* at 46. Those liabilities result in insurance costs for Fortune 500 companies that are six times higher than in Europe. *Id.* at 78.

A recent report commissioned by Senator Charles Schumer and New York City Mayor Michael Bloomberg

similarly warned that foreign companies are "staying away from US capital markets for fear that the potential costs of litigation will more than outweigh any incremental benefits of cheaper capital." BLOOMBERG & SCHUMER, SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP 101 (Dec. 2006), available at http://tinyurl.com/2fhyuf. The report recognized that "the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of business—and driven away potential investors." *Id.* at ii. Moreover, "the legal environments in other nations, including Great Britain, far more effectively discourage frivolous litigation." *Ibid.* As a result, New York's "pre-eminence in the global financial-services sector" is losing ground to London and other international business centers. Schumer & Bloomberg, *To Save New York, Learn From London*, WALL ST. J., Nov. 1, 2006, at A18; see also Atkins, *A Serious Threat to Our Capital Markets*, WALL ST. J., June 10, 2006, at A12 (SEC Commissioner Atkins explains that "[l]itigation risks * * * lessen the international appetite for our capital markets").

Section 10(b) suits are also burdensome to the federal government because they "consume significant judicial resources" and are "subsidized by the U.S. taxpayer." Coffee, *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534, 1540 (2006). Constituting almost half of all class actions pending in federal court in recent years, they are "the 800-pound gorilla that dominates and overshadows other forms of class actions." *Id.* at 1539-1540. In addition to "the sheer weight of their numbers, securities class actions disproportionately claim judicial time and attention" because "they take longer to resolve" and require the court "to play a more active monitoring role." *Ibid.*; see Alexander, *supra*, 43 STAN. L. REV. at 572 (describing the "cost to the public in judicial resources").

C. Lax Pleading Rules That Allow Meritless Claims To Evade Early Dismissal Create Disincentives To Full Disclosure To The Marketplace.

Allowing cases with speculative scienter allegations to evade dismissal undermines Congress's intent "to encourage the voluntary disclosure of information * * * about the financial condition of publicly traded companies." S. Rep. No. 104-98, at 5. Congress and the SEC understand that "[a]busive litigation severely affects the willingness of corporate managers to disclose information to the marketplace." H.R. Conf. Rep. at 42; see S. Rep. No. 104-98, at 9 ("Many companies refuse to talk or write about future business plans, knowing that projections that fail to materialize will inevitably result in a lawsuit"); SEC, Release No. 33-7107, 59 Fed. Reg. 52723, 52728 (1994) ("the threat of mass shareholder litigation * * * has had a chilling effect on disclosure of forward-looking information"). A firm that discloses information to the marketplace "takes the risk of excessive optimism and excessive pessimism." EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 339 (1991). Litigation "penalizing excesses in either direction" creates an incentive for management "to volunteer nothing" about the firm's prospects. *Ibid.*; H.R. Rep. No. 104-50, at 19.

Investors "want the issuer's own view of its future," which is "'the most valuable information shareholders and potential investors could have.'" KRIPKE, THE SEC AND CORPORATE DISCLOSURE 25 (1979); S. Rep. No. 104-98, at 15-16 (quoting former SEC Chairman Richard Breeden). But abusive securities litigation chills "the robustness and candor of disclosure." S. Rep. No. 104-98, at 15-16; see also H.R. Conf. Rep. at 31-32 ("the investing public and the entire U.S. economy have been injured by the unwillingness of * * * issuers to discuss publicly their future prospects, because of fear of baseless and extortionate securities lawsuits"). The risk of massive liability also muzzles companies' communications with analysts, which are "necessary to the preservation of a healthy market." *Dirks* v. *SEC*, 463 U.S. 646, 658-

659 (1983); see SEC, Release No. 33-7881, 65 Fed. Reg. 51716, 51718 n.19 (2000). When SEC disclosure requirements do not make silence an option, firms may respond with defensive disclosures that "bury the shareholders in an avalanche of trivial information." *TSC Indus.*, 426 U.S. at 448; see *Basic Inc.* v. *Levinson*, 485 U.S. 224, 231 (1988).

Permitting litigation based on speculative scienter theories to proceed past a motion to dismiss also burdens constitutionally protected speech in which there is a strong public interest. See *Lowe* v. *SEC*, 472 U.S. 181, 210 & n.58 (1985) (there is "no doubt about the protected character" of "the expression of an opinion about a marketable security," "factual information" about "market trends," and "commentary" on "market conditions"); *Nike, Inc.* v. *Kasky*, 539 U.S. 654, 664 (2003) (Stevens, J., concurring); *id.* at 676-678 (Breyer & O'Connor, JJ., dissenting). As the United States explained in *Nike*, the "First Amendment does not tolerate" an open-ended "private cause of action" for monetary relief against a company for "false statements respecting its products"—whether those statements "constitute 'commercial or noncommercial'" or hybrid speech—because such "unconstrained" actions pose "a serious threat of unjustifiable chill to legitimate speech on matters of public interest" and to "the free flow of information." 2003 WL 899100, at *7-8, *12, *20, *25.

A lax scienter pleading standard would detract from the quantity and quality of information provided to the marketplace. In adopting more stringent limits on private damages actions in the PSLRA, Congress sought to address that concern. H.R. Rep. No. 104-50, at 19. This Court has refused to interpret the Exchange Act in ways that undermine the free flow of information, and should do so once again here. *Dirks*, 463 U.S. at 658-659.

D. Section 10(b) Suits Enrich Plaintiffs' Lawyers But Provide Investors With Little Benefit.

Diversified investors are "fully compensated for [their] trading loses that are due to securities fraud by windfalls on

other transactions" and "have no need for further compensation obtained through litigation." Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1502 (1996); see Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 646 (1996) (diversified investors "have roughly the same chance of being winners as losers from securities fraud, and over time these gains and losses will tend to net out toward zero even in the absence of litigation"). This is because every delayed announcement of accurate firm information produces both winners (who sold during the period of inflation) and losers (who bought then and sold after disclosure of the truth). POSNER, ECONOMIC ANALYSIS OF THE LAW 489 (5th ed. 1998). "Over the long run, any reasonably diversified investor will be a buyer half the time and a seller half the time" and will not benefit from litigation forcing "his winning self to compensate his losing self over and over." EASTERBROOK & FISCHEL, *supra*, at 340.

A recent study confirms that diversified investors "generally break even from their investments in common stocks impacted by fraud allegations even prior to considering any recoveries through litigation." THAKOR ET AL., THE ECONOMIC REALITY OF SECURITIES CLASS ACTION LITIGATION 5-6 (U.S. Chamber Institute for Legal Reform 2005), available at http://tinyurl.com/ytyqtz. Punishing a company's shareholders with a Section 10(b) class action is therefore "like seeking to deter burglary by imposing penalties on the victim for having suffered a burglary." Coffee, *supra*, 106 COLUM. L. REV. at 1537.

Even "undiversified investors are seldom likely to receive a monetary benefit from the securities class action" because "the typical small, undiversified investor is likely to be a 'buy and hold' investor who does not trade frequently" and is thus "more likely to have purchased * * * stock before the class period commenced." Coffee, *supra*, 106 COLUM. L. REV. at 1559-1560. As a result, securities fraud class actions "transfer wealth systematically from 'buy and hold' investors

(who bought on average outside the class period) to more rapidly trading investors (who purchase on average within the class period)." *Id.* at 1560. "[T]he small investor who buys and holds for retirement" is thus "[t]he clearest loser" in securities class actions. *Ibid.* And "[t]he investors who are the most likely to be compensated through class action litigation—large institutional investors—are precisely those who are most diversified and thus are the least in need of compensation." Alexander, *supra*, 48 STAN. L. REV. at 1502. "From this perspective, recoveries from class action litigation represent a windfall to large investors." *Ibid.*; see THAKOR, ECONOMIC REALITY, *supra*, at 6 ("Large institutional investors are, in fact, often *overcompensated* as a result of litigation").

To make matters worse, shareholder plaintiffs "often receive only pennies on the dollar in damages" and incur significant transaction costs in the process. S. Rep. No. 104-98, at 9. The average securities class action settles for two to three percent of the investor's losses. Coffee, *supra*, 106 COLUM. L. REV. at 1545. These low percentages "are before the subtraction of the full costs that investors bear." *Id.* at 1546. Plaintiffs' attorneys received about one-third of the value of securities fraud settlements during the 1990s, with defense costs typically ranging from 25% to 35% of the settlement. *Ibid.* High defense costs "imply a higher insurance premium, as the insurer passes its costs back to the corporation and its shareholders." *Id.* at 1547. The company also bears "hidden costs," "including the costs of diverted managerial time, possible stigma, and damage to reputation." *Id.* at 1558-1559. When these costs are aggregated, "the sum may often exceed the net recovery to the class." *Ibid.*; see INTERIM REPORT at 79 (expressing doubt "that there is any positive recovery in the average securities class action").

In sum, securities fraud class action settlements are "largely paid by diversified shareholders to diversified shareholders and thus represen[t] a pocket-shifting wealth transfer that compensates no one in any meaningful sense and that incurs substantial wasteful transaction costs in the process."

INTERIM REPORT at 79; see Coffee, *supra*, 106 COLUM. L. REV. at 1583 ("Rule 10b-5 litigation in the secondary market 'stock drop' context essentially produces pocket-shifting wealth transfers that injure shareholders and do not protect the public interest"). See also Alexander, *supra*, 48 STAN. L. REV. at 1503: settlements "amount to transferring money from one pocket to the other, with about half of it dropping on the floor for lawyers to pick up."

E. Weeding Out Weak Section 10(b) Claims At The Dismissal Stage Serves The Policies Underlying The Securities Laws.

Section 10(b) suits of this kind provide shareholders with little—if any—net compensatory benefit. Furthermore, their "deterrent function" is questionable "because virtually all the costs fall on the corporation and its insurer, which means they are ultimately borne by the shareholders." INTERIM REPORT at 78; Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 952 (1993) ("the deterrent effect is weak" when "the merits of claims" are "irrelevant to their initiation or settlement values"). Accordingly, requiring plaintiffs to satisfy rigorous scienter pleading standards will not undermine the deterrence and compensation policies of the securities laws. Other remedies are available that amply protect investors from corporate misrepresentations and non-disclosures without causing the harms and transaction costs we have described.

SEC regulations impose stringent reporting obligations. Corporations must file regular financial statements. 15 U.S.C. §§ 7241, 7243; 18 U.S.C. § 1349. Issuers also must file Form 8-K reports on any of a host of material corporate events, including agreements, acquisitions, disposition of assets, off-balance sheet financial obligations, and changes in officers or directors. SEC, Release No. 33-8400, 69 Fed. Reg. 15594 (2004). To enforce these disclosure obligations the SEC may obtain injunctive relief, cease-and-desist orders,

orders barring or suspending individuals from serving as an officer or director of an issuer of securities, and large civil penalties, including disgorgement of gains. 15 U.S.C. §§ 78u, 78u-3; see *SEC* v. *First Jersey Sec.*, 101 F.3d 1450 (2d Cir. 1996) (requiring disgorgement of $75 million). The SEC may earmark penalties and amounts disgorged "for the benefit of the victims" of the violation. 15 U.S.C. § 7246(a).

In addition, a person who willfully and knowingly makes a false or misleading statement of material fact may be held criminally liable and sentenced to imprisonment for 20 years and multi-million dollar fines. 15 U.S.C. § 78ff. Insiders who trade with knowledge of material information that has not been disclosed to the public face civil penalties of three times the profit gained or loss avoided. *Id.* § 78u-1. The Securities Act authorizes similar remedies for misstatements made in connection with the registration of securities, for which liability may be established without proof of scienter. *Id.* §§ 77t, 77y.

The SEC is not reluctant to use its powers. Former Chairman Richard Breeden described the goal of SEC enforcers as leaving securities law violators "naked, homeless, and without wheels." Eisenberg, *Enforcement Issues and Litigation*, 21 SEC. REG. L.J. 421, 421 (1994). In the aftermath of the bubble and recent corporate insolvencies, the Commission's 900-strong enforcement staff has shown extraordinary vigor. During fiscal year 2006 alone, the SEC initiated 914 investigations of possible violations of the securities laws and brought 218 suits and 356 administrative proceedings against issuers and financial service providers. The SEC obtained orders requiring the payment of more than $3.3 billion in disgorgement and penalties from securities law violators. SEC, 2006 PERFORMANCE AND ACCOUNTABILITY REPORT at 8, available at http://tinyurl.com/ygyfv8. In addition, the Department of Justice's Corporate Fraud Task Force has charged over 1,300 defendants and obtained over 1,000 guilty pleas and convictions since it was formed in July 2002. See Department of Justice, Fact Sheet: Corporate Fraud Task

Force (Aug. 9, 2006), available at http://tinyurl.com/yhj2v2. State prosecutors and blue sky officials may bring their own overlapping enforcement actions, and in cases involving the financial services industry self-regulatory organizations like the National Association of Securities Dealers ("NASD") and the New York Stock Exchange ("NYSE") enforce regulations that implement and supplement the securities laws.[2]

Securities market participants are hemmed in by an array of governmental powers, civil and criminal, that curb unlawful practices and compensate non-speculative injuries. As Judge Friendly observed, "[t]he important thing is to stop the evil conduct" and "an injunction," "fines," or other sanctions imposed at the behest of expert regulators achieve that purpose without "ruin[ing] innocent stockholders," "produc[ing] blackmail settlements," or "deterring desirable conduct." FRIENDLY, *supra*, at 120. Accord *Piper* v. *Chris Craft*, 430 U.S. 1, 40 & n.26 (1977) ("injunctive relief * * * is apt to be the most efficacious form of remedy" for securities law violations). Together, these checks curb unlawful practices and compensate genuine injuries. Given the availability of these remedies, there is no reason for this Court to allow Section 10(b) suits to proceed on the basis of conclusory allegations and speculative theories, as permitted by the liberal scienter pleading standards endorsed by the Seventh Circuit.

III. THE SEVENTH CIRCUIT SET THE THRESHOLD FOR PLEADING SCIENTER FAR TOO LOW.

Under any plausible reading of the PSLRA's strong inference standard for pleading scienter, the allegations here do not pass muster.

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[2] *E.g.*, NASD Notice to Members 99-86, *Imposition and Collection of Monetary Sanctions* (Oct. 1999), available at http://tinyurl.com/y3slbo (discussing fines, restitution, and disgorgement); see also NYSE Information Memo 05-77, *Factors Considered by the NYSE Division of Enforcement in Determining Sanctions* (Oct. 7, 2005), available at http://tinyurl.com/y3ro8p.

1. This Court's decisions establish two fundamental rules of pleading that bear decisively on this case. First, a complaint must allege facts, not merely conclusions, that show the plaintiff is entitled to relief under the governing substantive law. Second, it is the facts alleged, not unalleged facts that the plaintiff might later prove, that must support the claim for relief.

When a defendant tests the legal sufficiency of a pleading by filing a motion under Rule 12(b)(6), courts accept the *facts* alleged in the complaint as true for purposes of evaluating whether the complaint "state[s] a claim upon which relief can be granted." Fed. R. Civ. P. 12(b)(6); see *Leatherman* v. *Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 164 (1993). By contrast, courts need not accept the truthfulness of allegations that are merely conclusions, characterizations, or inferences.[3]

Policing this distinction between well-pleaded facts and conclusory assertions and inferences is necessary to ensure that a complaint "provide[s] the defendant with 'fair notice of what the plaintiff's claim is and the grounds upon which it rests.'" *Dura Pharms.*, 544 U.S. at 346 (quoting *Conley* v. *Gibson*, 355 U.S. 41, 47 (1957)). As Judge Boudin observed:

> [T]he price of entry, even to discovery, is for the plaintiff to allege a *factual* predicate concrete enough to warrant further proceedings, which may be costly and burdensome. Conclusory allegations in a complaint, if they stand alone, are a danger sign that the plaintiff is engaged in a fishing expedition.

DM Research, Inc. v. *Coll. of Am. Pathologists*, 170 F.3d 53, 55 (1st Cir. 1999).

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[3] See, *e.g.*, *Papasan* v. *Allain*, 478 U.S. 265, 286 (1986); *Veney* v. *Wyche*, 293 F.3d 726, 730 (4th Cir. 2002); *Dry* v. *United States*, 235 F.3d 1249, 1255 (10th Cir. 2000); *Doug Grant, Inc.* v. *Greate Bay Casino Corp.*, 232 F.3d 173, 184 (3d Cir. 2000); *In re Sofamor Danek Group, Inc.*, 123 F.3d 394, 400 (6th Cir. 1997).

Accordingly, "a complaint must allege, at a minimum, a sufficient factual predicate * * * to demonstrate a reasonable basis for inferring that the alleged conduct may be wrongful." Brief for the United States as Amicus Curiae Supporting Petitioners at 6, *Bell Atl. Corp.* v. *Twombly*, No. 05-1126 (Aug. 25, 2006) ("U.S. *Twombly* Br."); see *Warth* v. *Seldin*, 422 U.S. 490, 504 (1975). Furthermore, when testing the sufficiency of a complaint, "[i]t is not * * * proper to assume that the [plaintiff] can prove facts that it has not alleged." *Associated Gen. Contractors of Cal., Inc.* v. *Cal. State Council of Carpenters*, 459 U.S. 519, 526 (1983); see also *Wilson* v. *Schnettler*, 365 U.S. 381, 383 (1961).

Courts may consider "the potential magnitude of the case, and the policies behind the securities laws," in deciding whether to dismiss a complaint under Rule 12. U.S. *Twombly* Br. at 13. Thus, where "a case involves a 'potentially massive factual controversy,'" courts retain the power to require "more 'specificity in pleading.'" *Id.* at 17 (quoting *Associated Gen. Contractors*, 459 U.S. at 528 n.17). Using that power in sprawling securities fraud class actions is particularly appropriate for two reasons. First, because the scienter element of a securities fraud claim "critically distinguishes innocuous * * * conduct from wrongdoing, allegations concerning that element must be concrete, rather than conclusory." *Id.* at 12. Second, failing to require concrete allegations "would permit a plaintiff 'with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the [discovery] process will reveal relevant evidence.'" *Dura Pharms.*, 544 U.S. at 347.[4]

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[4] See also *Reiter* v. *Sonotone Corp.*, 442 U.S. 330, 345 (1979) (encouraging district courts to "use the tools available" to avoid "administrative chaos, class-action harassment, or 'windfall' settlements"); *Davis* v. *Passman*, 442 U.S. 228, 237 n.15 (1979) ("sufficient detail must be given so that the defendant, and the court, can

2. These ordinary pleading principles apply *a fortiori* to the scienter requirement under the PSLRA because Congress has "unequivocally raise[d] the bar" for pleading that element. Pet. App. 18a. The PSLRA requires that a complaint "state *with particularity* facts giving rise to a *strong inference* that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (emphasis added). This heightened standard "alters the normal operation of inferences under Fed. R. Civ. P. 12(b)(6)." *In re Digital Island Sec. Litig.*, 357 F.3d 322, 328 (3d Cir. 2004). To give it effect, plaintiffs in a case covered by the PSLRA must plead facts that strongly tend to exclude the possibility that the defendant acted with an innocent state of mind. See Pet. 23-25; Pet. App. 23a; see generally *Matsushita Elec. Indus. Co.* v. *Zenith Radio Corp.*, 475 U.S. 574, 588 (1986).

A contrary rule that requires district judges "to consider only inferences favorable to [plaintiffs'] position" would "eviscerate the PSLRA's strong inference requirement by allowing plaintiffs to plead in a vacuum." *Gompper* v. *VISX, Inc.*, 298 F.3d 893, 896 (9th Cir. 2002); see also *In re Credit Suisse First Boston*, 431 F.3d 36, 51 (1st Cir. 2005) (Rule 12 "does not require the court, in a PLSRA case, to turn a blind eye to the universe of possible conclusions stemming from a given fact or set of facts"); *Pirraglia* v. *Novell, Inc.*, 339 F.3d 1182, 1187 (10th Cir. 2003) ("Whether an inference is a strong one cannot be considered in a vacuum"). It would allow any competent plaintiffs' lawyer to establish a strong inference of scienter through artful pleading and "would thwart Congress's basic purpose in raising the bar in the first place; namely, to eliminate abusive and opportunistic securities litigation." *Gompper*, 298 F.3d at 897.

3. When the Court disregards conclusory assertions and focuses on the facts actually alleged, the complaint in this case does not come close to supporting a strong inference of

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obtain a fair idea of what the plaintiff is complaining, and can see that there is some legal basis for recovery").

scienter. The Seventh Circuit analyzed four categories of allegedly false statements by Tellabs' CEO, Richard Notebaert, to determine whether the complaint adequately alleged scienter. Pet. App. 10a, 22a. The petition thoroughly discusses each category (at 7-12, 26-28). Two examples are sufficient to show how badly the Seventh Circuit misperceived the governing pleading standard.

First, the complaint alleges that Notebaert overstated the demand for Tellabs' TITAN 5500 product in February and March 2001. Pet. App. 12a. The complaint appears to acknowledge, however, that information about the decline emerged over several months. It does not specify when external and internal reports documenting the decline were distributed, much less when (if at all) Notebaert saw those reports. Pet. App. 65a. Thus, plaintiffs have alleged no facts creating a strong inference that Notebaert had knowledge contrary to his general optimistic statements. And it is improper to assume they could prove unalleged facts at trial.

The Seventh Circuit observed that an internal report revealing the drop in demand was written sometime in March 2001. Pet. App. 23a. But the statements that the Seventh Circuit identified as false were made in February and on March 8. *Id.* at 12a. The only subsequent statement it could find was a remark in April about growing demand for Tellabs' services generally. *Id.* at 23a. On April 6, Tellabs disclosed an unanticipated drop in TITAN 5500 orders during the last two weeks of March and lowered its revenue projections accordingly. Pet. 27. These facts do not strongly tend to exclude the possibility that Notebaert made his positive statements without knowledge that demand had declined.

Second, the complaint alleges that Tellabs inflated its financial results for the fourth quarter of 2000 by engaging in "channel stuffing"—inducing purchasers to buy TITAN 5500s earlier than in the normal course. Pet. App. 13a, 55a-59a; *Greebel* v. *FTP Software, Inc.*, 194 F.3d 185, 202 (1st Cir. 1999). It alleges that Notebaert knew about the channel

stuffing and worked with sales personnel to effect it. Pet. App. 25a. As the complaint defines channel stuffing, however, it is a label that applies to legitimate discounting, which is desirable and efficient conduct, as well as to illegitimate practices. Pet. 28; *Greebel*, 194 F.3d at 203 ("there may be any number of legitimate reasons for attempting to achieve sales earlier"); see also *Broudo* v. *Dura Pharms., Inc.*, 339 F.3d 933, 940 (9th Cir. 2003), *rev'd on other grounds*, 544 U.S. 336 (2005). Accordingly, as the district court held and the Eleventh Circuit recently confirmed, the general allegation that Notebaert promoted channel stuffing does not establish scienter. Pet. App. 74a; *Garfield* v. *NDC Health Corp.*, 466 F.3d 1255, 1265 (11th Cir. 2006).

Plaintiffs do allege that some of the channel stuffing consisted of illegitimate fabrication of purchase orders by Tellabs employees, but they do not allege that Notebaert had any knowledge of such fabrication. Thus, they have not pleaded particular facts that strongly tend to exclude the possibility that Notebaert acted with an innocent state of mind.

4. The Seventh Circuit's decision may not be upheld based on generalized allegations that Notebaert had the "motive and opportunity" to commit securities fraud. Some courts have adhered to a pre-PSLRA rule first adopted by the Second Circuit that allows plaintiffs to establish scienter "by pleading either motive and opportunity or strong circumstantial evidence of recklessness or conscious misbehavior." *Novak* v. *Kasaks*, 216 F.3d 300, 309-310 (2d Cir. 2000). The "motive and opportunity" test was flawed even before the PSLRA because it "'lower[ed] the bar for securities fraud cases below that mandated by * * * *Hochfelder*.'" *Bryant* v. *Avado Brands, Inc.*, 187 F.3d 1271, 1286 (11th Cir. 1999). Almost "every highly ranked executive of a company could be said to have the motive and opportunity to profit by misstatements." *Fla. State Bd.* v. *Green Tree Fin. Corp.*, 270 F.3d 645, 655 (8th Cir. 2001); see *Bryant*, 187 F.3d at 1286 ("Greed is a ubiquitous motive, and corporate insiders and upper management always have opportunity to lie and ma-

nipulate"). By presuming that "anyone who has the chance to profit by wrongdoing is likely to do so," the motive and opportunity test enables plaintiffs to evade dismissal in virtually all Section 10(b) suits. *Fla. State Bd.*, 270 F.3d at 655.

To the extent that the motive and opportunity test was ever proper, it is now clear that "allowing private securities class actions to proceed to discovery upon bare allegations of motive and opportunity would upset the delicate balance of providing a remedy for genuine fraud while preventing abusive strike suits that the [PSLRA] sought to achieve." *Bryant*, 187 F.3d at 1286. Indeed, Congress expressly rejected a proposal to codify the motive and opportunity test, explaining that it "intend[ed] to strengthen existing pleading requirements" and thus "chose not to include in the pleading standard certain language relating to motive [and] opportunity." H.R. Conf. Rep. at 41 & n.23; see *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 979 (9th Cir. 1999) (Congress "rejected the 'motive and opportunity'" test). Accordingly, plaintiffs must plead facts that give rise to a "strong inference" that the defendant acted with "intent to deceive, manipulate, or defraud" in order to avoid dismissal under the PSLRA. *Hochfelder*, 425 U.S. at 193.[5]

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[5] This Court has "explicitly left open the question of whether recklessness satisfies the scienter requirement." *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 378 n.4 (1983) (citing *Hochfelder*, 425 U.S. at 194 n.12). In "'an area that demands certainty and predictability,'" *Central Bank*, 511 U.S. at 188, the recklessness standard is "too amorphous" and "belies the existence of a bright line test." 3 HAZEN, THE LAWS OF SECURITIES REGULATION § 12.8, at 258, 261 (5th ed. 2005). This "uncertainty" has caused some "reluctan[ce] to grant summary judgment in 10b-5 cases where scienter is a contested issue," *id.* at 261, and thus undermines Congress's intent in enacting the PSLRA. Accordingly, this Court should require plaintiffs to plead facts that give rise to a strong inference that the defendant acted with intent to deceive in order to survive a motion to dismiss. See *Dirks*, 463 U.S. at 663 n.23 (Section 10(b) requires "'intent to deceive'").

5. The Seventh Circuit erred by suggesting that heightened pleading standards applied by other circuits "could potentially infringe upon plaintiffs' Seventh Amendment rights." Pet. App. 20a. The Seventh Amendment does not bar Congress from specifying a procedure that may incidentally result in a case being decided by a court rather than a jury. See *Leatherman*, 507 U.S. at 168 (Congress may create heightened pleading standards); *Swierkiewicz* v. *Sorema N.A.*, 534 U.S. 506, 515 (2002) (same); *Galloway* v. *United States*, 319 U.S. 372, 389-390 (1943) (holding that a directed verdict practice approved by Congress does not violate the Seventh Amendment); Fed. R. Civ. P. 9(b) (requiring plaintiffs to plead "the circumstances constituting fraud or mistake * * * with particularity"); see also 8 MOORE'S FEDERAL PRACTICE § 38.12 (3d ed. 2006) (the "Seventh Amendment Does Not Regulate Matters of Pleading and Practice").

CONCLUSION

The judgment of the court of appeals should be reversed and the district court's judgment dismissing the complaints with prejudice reinstated.

Respectfully submitted.

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